

THE ECONOMIC SITUATION

Bruce Yandle

Dean Emeritus,

College of Business & Behavioral Science, Clemson University

Director, Strom Thurmond Institute Economic Outlook Project

yandle@clemson.edu

To add your name to the report email list, please send an email to Kathy Skinner. She is kathy@strom.clemson.edu.

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Yes, we *still* have no bananas

Those who read my January special report on the 2008 economy will recall the anecdote about White House economist Fred Kahn and the Carter Administration's fear of recession. The Carter folks became so paranoid that they tried to muzzle federal officials to prevent them from uttering the R-word itself. It was in that environment that economist Kahn started referring to recessions as bananas. Yes, he said, in answer to a question during a congressional hearing on the economy, we may have a banana after all.

Yes, I said in January, we have no bananas. In short, I could not see evidence of an approaching recession.

We still have no bananas. And it is amazing how those who said we were already in a banana in January or since now quickly change the subject when asked about the economic situation. Of course, our time of tribulation is not over.

By the way, someone asked me this week after hearing my presentation on the economy, what an optimistic economist is called? Answer: Unemployed.

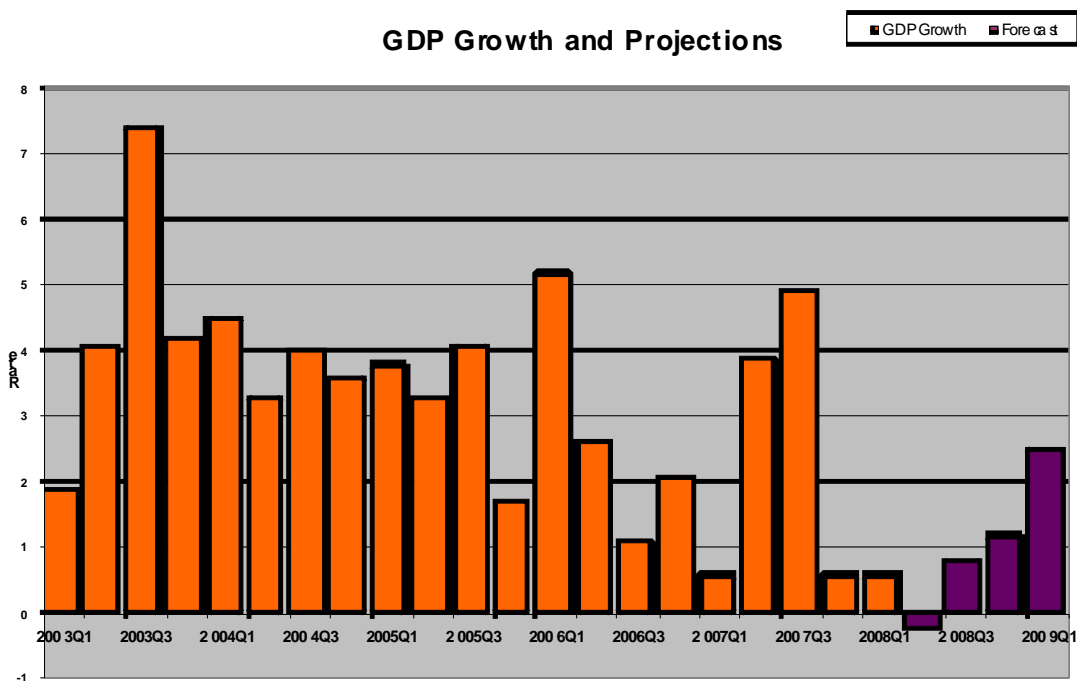
The cheering facts

Sometimes we have to accept the facts no matter how cheering they may be. Let's look at some data and see what they tell us.

Warning: Those who love bad news might best skip the next section.

The next chart shows GDP growth with the latest Commerce Department's advanced estimate for 1Q2008. First quarter 2008 came in with 0.6% growth. Remember this was a quarter when practically everyone, including this joyful one, felt we would see negative growth. The number, just equal to 4Q2008, is pretty weak, but it is not negative.

We now have two quarters with low positive growth. My estimate for the next few quarters, now revised, indicates that I remain in the no recession camp. While resting here, I should note that it gets sort of lonesome in these "no recession" woods. I should also report that there are some pretty dark clouds in the sky, along with occasional blasts of sunshine.



The mixed bag economy

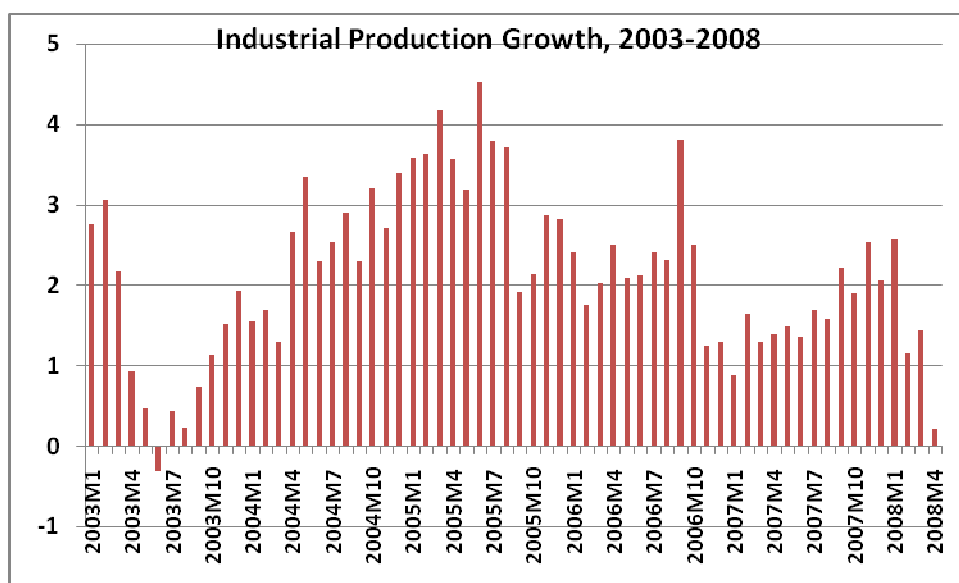
Data on the larger economy are a mixed bag for sure. For example, April Industrial Production, which measures the real output of manufacturing, mining, and electric utilities, came in with a negative 0.7% growth rate. March was at least positive. The number was 0.2%. But then February had rolled in with another negative 0.7%. It is a bouncing ball, driven largely in the negative direction by a stumbling auto industry.

Let's face it, credit is tight. Household budgets are even tighter. Auto shopping is not high on the family agenda even with practically give-away interest rates.

But within manufacturing, computer and electronics is the one hot area. And while domestic demand is apparently weak, there is a quickening pulse beat coming from

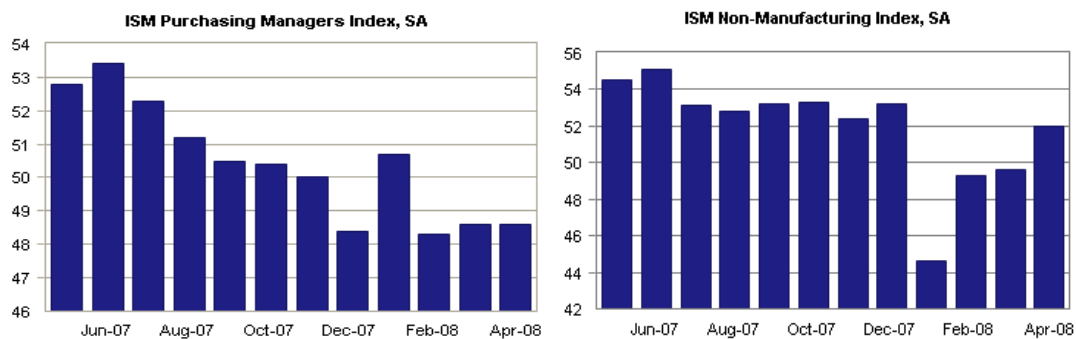
international markets. The declining value of the dollar against the currencies of major trading countries has put American producers in a strong position.

The next chart shows industrial production growth in terms of same month annual growth rates. The last observation for April 2008 compared with April 2007 shows growth of 0.20%. Seen this way, the data show the sharp April reduction. We should expect the month-over-month growth for May to be negative.



More mixed data

The next two charts report Institute of Supply Management monthly data on manufacturing and non-manufacturing (services) activity. The charts are taken from Economy.com. The indexes take a value of 50 when the economy is in neutral. Less than 50 means the economy is losing ground; higher than 50 says growth is positive. Things don't look so hot for the manufacturing economy. Much happier data are seen non-manufacturing production index where the pulse beat for services is above 50. Remember, the services economy is the larger of the two.

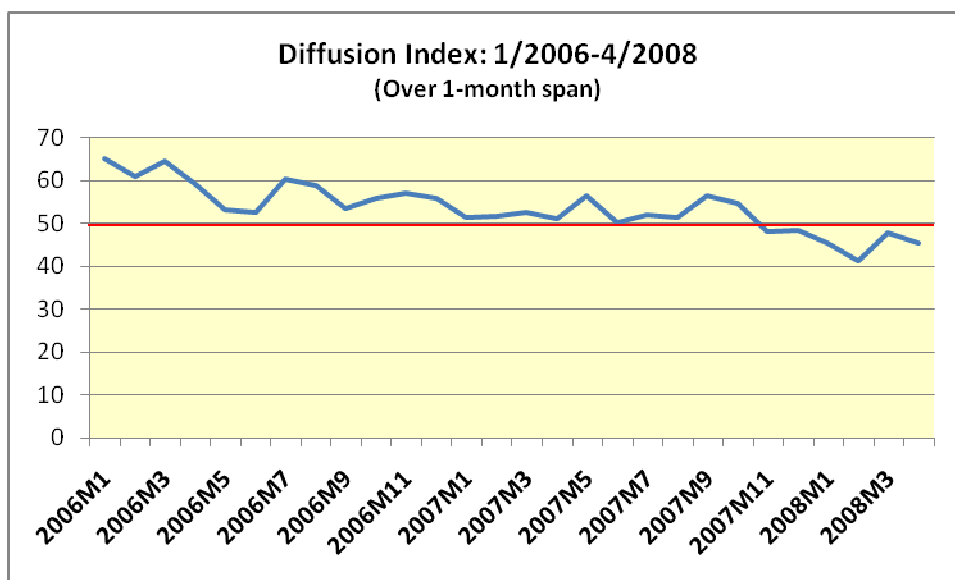


What about employment?

Here's some good news. The U.S. unemployment rate has hardly moved in the last few months. Keep in mind, most commentators and some presidential candidates said we were falling into an abyss. The share counted unemployed in April was 5.0%, down a shade from March's 5.1%. To get a feel for the trend, consider this: In November 2007, the unemployment rate stood at 5.0%. Then the number fell slightly, hitting 4.7% in February before rising to 5.1% in March. Any way you cut the data, the share unemployed doesn't reflect recession or end-of-world conditions.

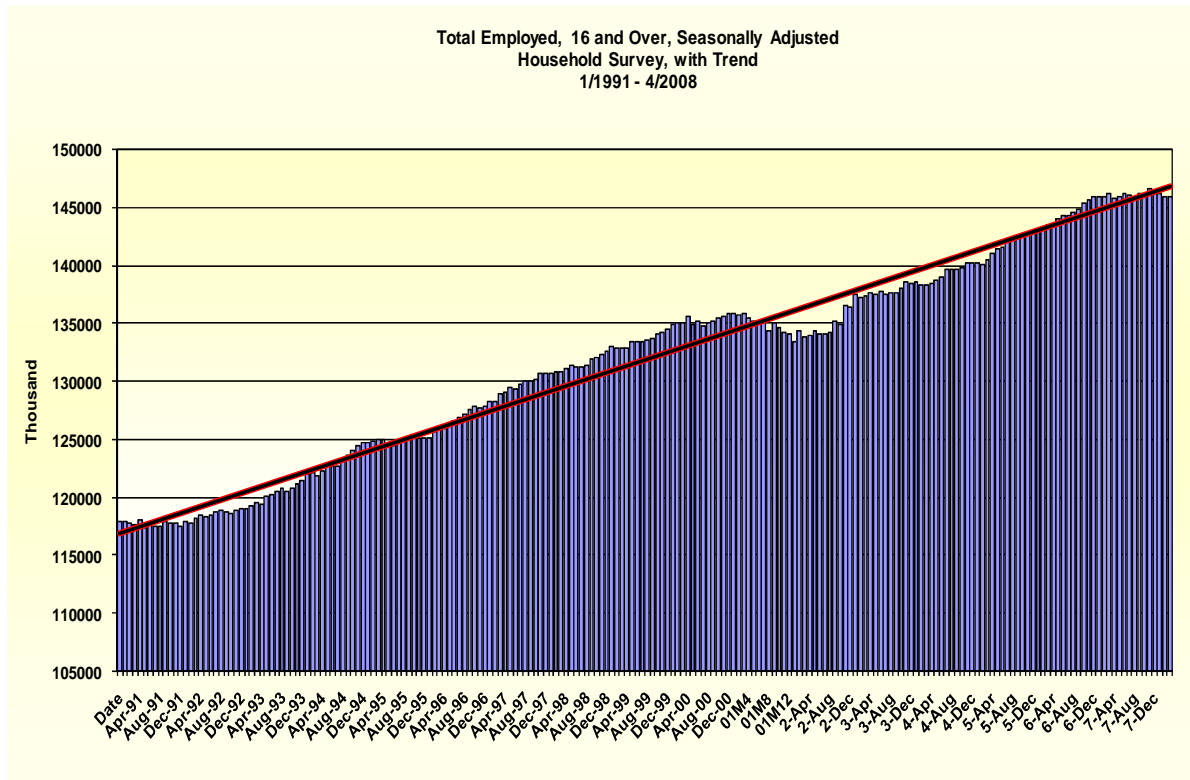
Of course, we understand that it is in the interest of politicians, no matter the political stripe, for things to look bad. If bad enough, they will tell us how by spending more money, they would make things better. Or if really bad, they can tell us why we need to cut the size of government to fit diminishing revenues. No matter the stripe, bad news seems preferred to good.

While the national unemployment rate has not moved into bad territory, there is a concern about how employment growth is spread across industries. The next chart shows data from the Bureau of Labor Statistics employment diffusion index. The index gives a reading on how employment is spreading or shrinking across 274 industries. A number greater than 50 says more sectors are hiring than firing. Below 50, not so good. As indicated, diffusion is in the shrinking economy territory.



A closer look at employment

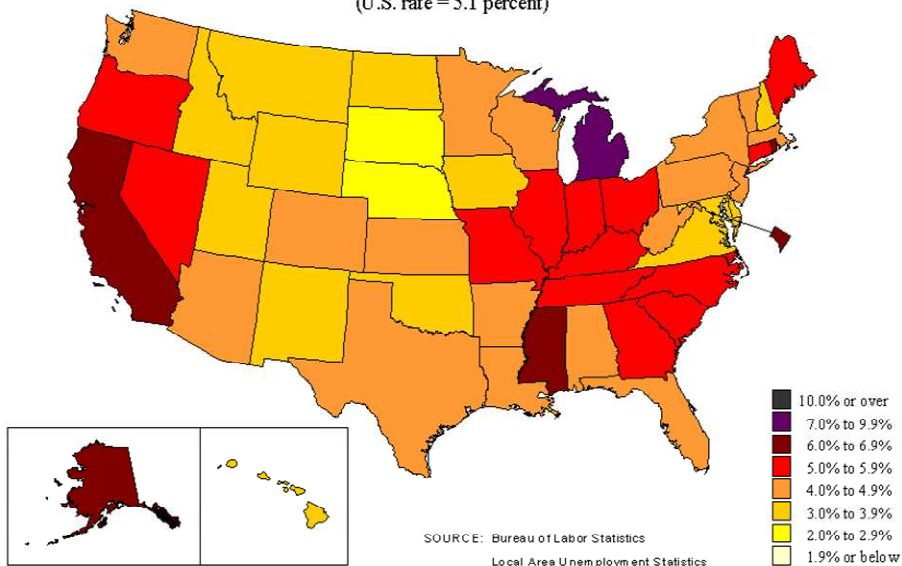
How bad is it? And where is it worse? Let's now turn to total employment. The next chart shows total U.S. employment using household employment survey data. The gap between the trend line and the bars has become a bit more visible recently, but still nothing like the picture seen in 2001-2002.



The economic geography of unemployment is seen in the next two maps. A comparison of March 2008 with August 2007 shows the slowing economy is very much an east of Mississippi and west coast phenomenon. The darker states also identify the location of the bulk of the sub-prime problem. Two regions tell the tale. The older industrial regions that still suffer from declining Big-Three auto and steel production and California, Nevada, and south Florida, with a few other rough spots scattered here and there.

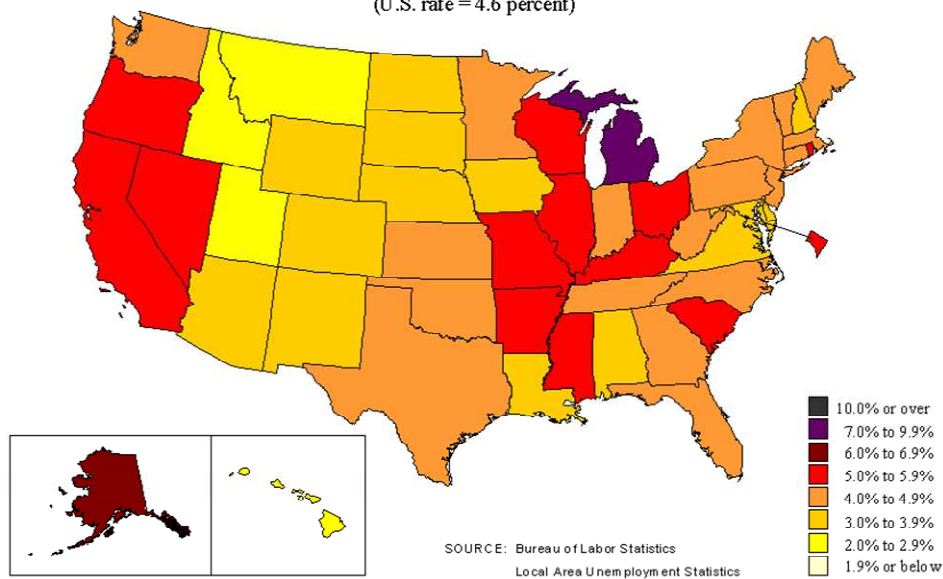
**Unemployment rates by state,
seasonally adjusted, March 2008**

(U.S. rate = 5.1 percent)



**Unemployment rates by state,
seasonally adjusted, August 2007**

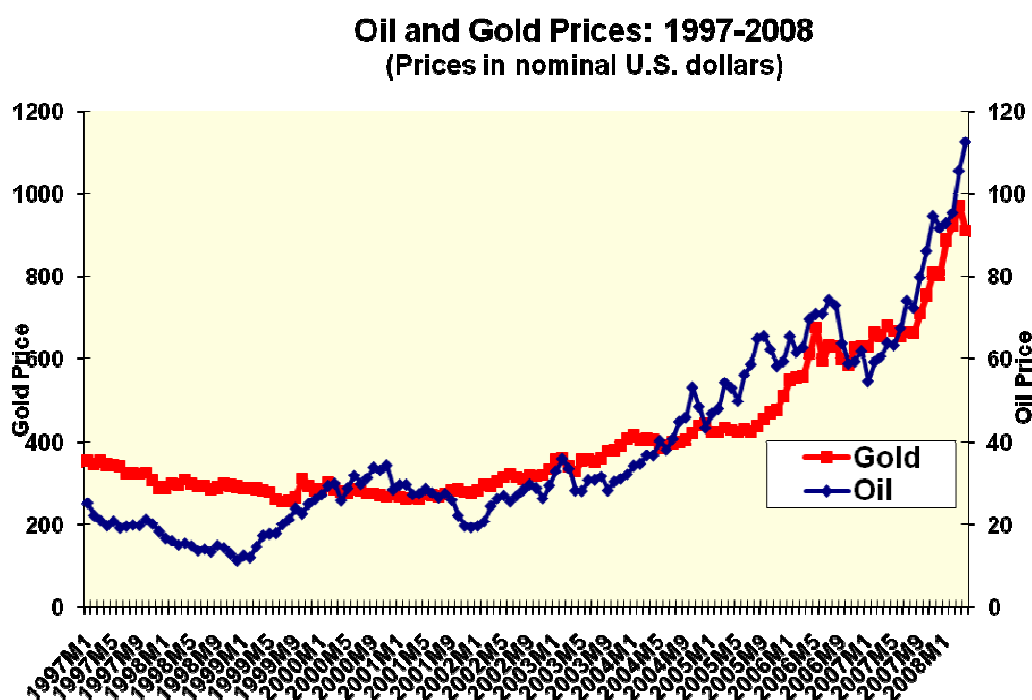
(U.S. rate = 4.6 percent)



Oil and gas: When will the run-up end?

Since December 2007, the price of intermediate crude oil has risen from \$91 to \$125, some 33%. (Since June 2007, the price has almost doubled.) As shown in the accompanying chart, the price of gold during the same period has risen from \$803 an ounce to \$910, which is about 12%. There are some 20 percent points separating those two numbers. What's going on?

What explains the 20 percentage point gap?



I view the dollar price of gold as being driven primarily by expected inflation. Inflation expectations also affect the price of oil, but apparently something else is at play in this year's first quarter. What might it be? And when will it let up?

I could point to supply disruptions, such as the practical shut down of Nigerian shipments, the disruptions in Russia, and the unhappy camper who is head of state in Venezuela. Since some 95% of the world crude oil production is politically controlled, we will continue to have these disruptions. Even so, I do not believe there have been that many compounded disruptions since December.

Another explanation for higher priced oil points to the growing demand from China and India, but demand there has not suddenly increased. In fact, demand has decreased. So where do we look next.

There is the weaker dollar. This is part of the problem, but the weakness has not accelerated, and the change is not large enough to explain oil's higher price.

Finally, there are commodity speculators who think oil prices will continue to shoot toward the heavens; there are data to suggest that western nations are holding larger inventories for that same reason.

I think the speculators are wrong, that inflation forces will let up and that supply conditions will improve. In other words, I think we can look forward to a recovery of some 20% in the price of oil and gasoline in the next six months. That will bring oil to \$100 and gasoline at the pump to about \$2.70 in South Carolina.

In an effort to make this happen, President Bush went to Saudi Arabia with a special plea for more oil. His plea seemed to fall on deaf ears, at least outwardly. The president of Exxon suggested that if Mr. Bush is going to beg for more production, he might have a better case with state governments in the U.S. that limit drilling, production, and shipment of oil. But, let's face it, neither Mr. Bush nor Exxon ranks very high in public opinion polls.

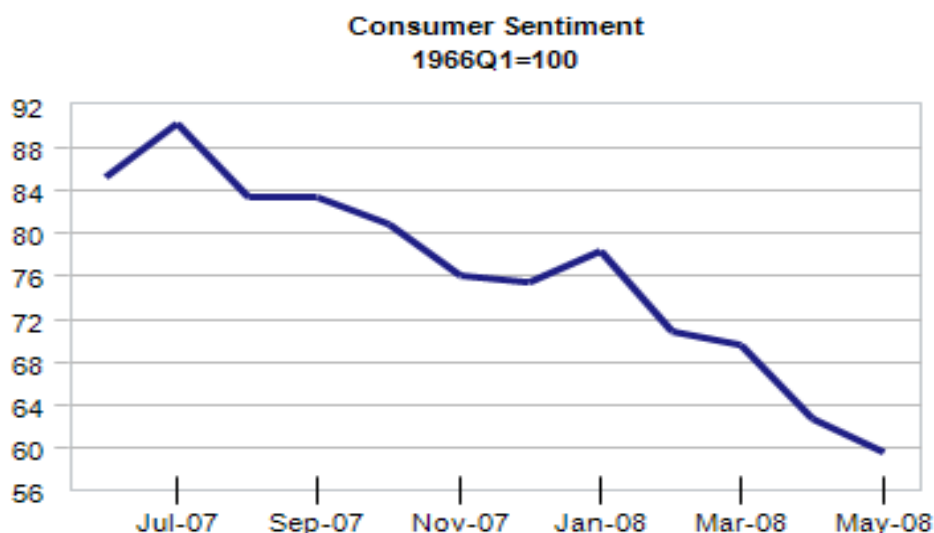
While Mr. Bush was in Arabia, Congress moved to end temporarily the continued pumping of oil into the Louisiana salt mine strategic reserve. The closed spigot stops an inflow of 70,000 barrels a day, which is about 0.3% of the nation's daily habit. Some say this may reduce the U.S. price of gasoline by as much as three or four pennies a gallon. Others say world markets determine the price of crude and the world won't know the difference. Meanwhile, the nation has about a 30 day supply of crude resting quietly in Louisiana.

Little things mean a lot.

Things look better for the longer term. There is a supply response being generated by the higher prices, as well as newly identified conservation actions. And while I am optimistic about oil prices, I may not be quite as optimistic as the U.S. Department of Energy. Their long-term forecast calls for oil to fetch \$68 a barrel in seven or eight years. Don't trash those SUVs yet.

The Four Ds one more time

Readers will recall the 4-Ds, the device borrowed from economist Don Ratajczak that I introduced in March for tracking the recession. The first D is for Depth: How deep is the economic slump? The second D is diffusion: How widespread is the slowdown? The third is Duration: How long? And the fourth is Despair: What are people saying about hard times? I have discussed elements of the first three Ds in the earlier sections of the report. I now report Economy.com's chart on the University of Michigan's consumer sentiment index. If you are looking for despair, travel no further. The combination of near \$4.00 gasoline, bad news spread by presidential candidates, mortgage defaults, and tightened credit lead to the lowest reading since June 1980. Despair? It's there.



The next table provides a 4-D summary. Recession is just not there, folks...., yet.

Recession Watch: The Four Ds

D1: Depth	D2: Diffusion	D3: Duration	D4: Despair
January , February, & March show drop in payroll employment. April decline is small. December, January & March retail sales data are flat, but consumer spending is rising. Industrial Production growth for the first four months is negative. Preliminary 1Q2008 GDP growth is positive (0.6%). The first four months are borderline as recession months, but not quite there.	A reading less than 50 is a sign that job losses are expanding across sectors. January Diffusion Index is 45.4. 41.4 for February. 48.0 for March, and 45.4 for April. Supply Chain Managers index for industrial economy is stable at 48.5 for March and April, after falling lower. The ISM services economy index turned weak in January but then improved. March is 49.6. January through April barely qualify as recession months.	Too early to tell.	Sharp decline in various consumer confidence indexes. Compares with previous recession periods. January through April qualify as recession months.

Want to be an angel investor?

Take a look at the picture here. I borrowed it from Russ Sobel, a professor at West Virginia University. Russ asked the question: would you have invested in this bunch in 1978? Don't look too promising, do they. Well, look again. That is Bill Gates in the lower left-hand corner! Sobel makes the point that we cannot know which entrepreneurs will be successful or which will fail. The market and angel investors do the sorting for us, and they aren't perfect either.



Oh yes, if you had invested \$1,000 in 1986 when Microsoft first went public, the investment would be worth a tidy \$386,000 today. How many millionaires generated by this cool looking group? Some 10,000, it is said.

So, next time you feel like scolding a young person about hair and dress, you might think again.

How about this? Give a man a fish and he is fed for a day. Teach a man to fish and he is fed for a lifetime. Encourage an entrepreneur and thousands may feed themselves for a lifetime while millions enjoy the benefits of a new product.

Let us celebrate free markets!

Carolina Digest

While there are surely serious economic problems in some large U.S. markets, that is not the case in South Carolina. The economic punchbowl that some say was taken away from California, Nevada, and Southern Florida never quite got filled with sub-prime juice in South Carolina. No rapid run-up in prices, generally speaking, and no severe price collapse here.

The next data illustrate the point. Here we see 2007 house price changes for South Carolina and several S.C. metro areas. The data are for the year, and they relate to Fannie Mae and Freddie Mac repeat transactions. Price increases are not good news to buyers, but price changes at the inflation level are considered a healthy sign. On the dark side, California prices fell 6.6% in 2007; Florida saw a 4.7% decline. Of course, much larger decreases are being registered in particular metro areas in those two states.

Percent Change in House Prices, 2007

	%	Rank
United States	- 0.3%	
South Carolina	3.7%	18
Anderson	3.04%	91
Augusta-Richmond	5.95%	26
Charleston	1.99%	132
Columbia	2.91%	99
Florence	2.38%	120
Myrtle Beach	2.80%	106
Spartanburg	5.35%	35

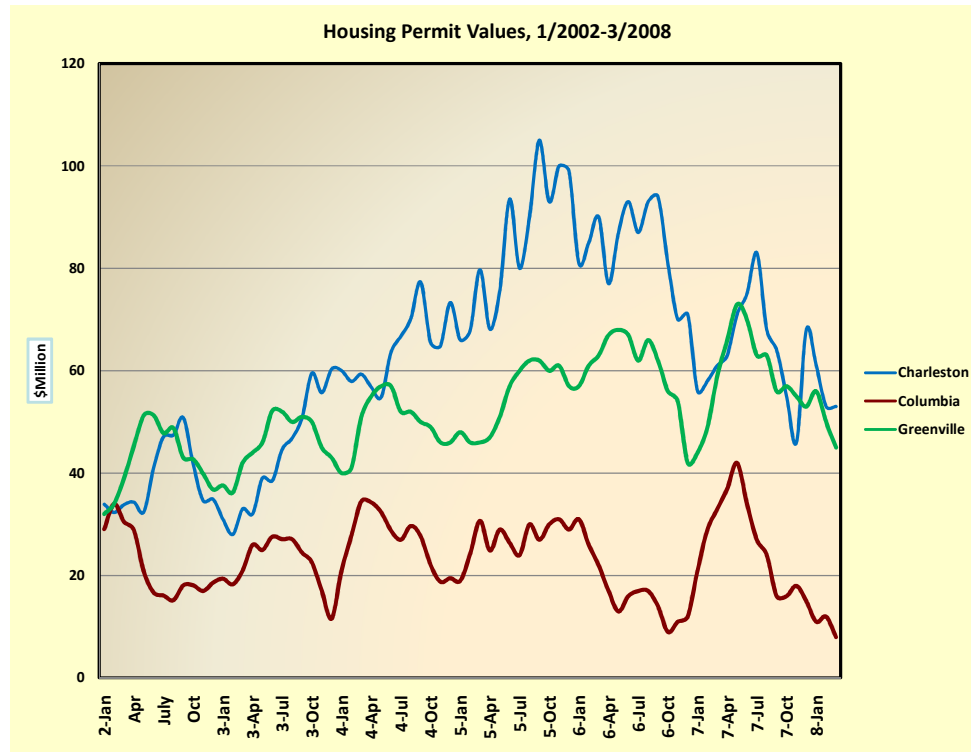
Office of Federal Housing Enterprise Oversight. Ranking for 291 MSAs.

Employment growth is another respected sign of economic health. Recent metro area data released by the Bureau of Labor Statistics indicate good health in most of S.C. metro areas. In fact, the growth rate for Florence put that area at number three in the nation.

Employment Growth
S.C. Metro Areas: 2/2007 to 2/2008

Anderson	-1.4%
Augusta	1.3%
Charleston-North Charleston Summerville	2.1%
Columbia	1.9%
Florence	4.7%
Greenville-Mauldin-Easley	2.9%
Myrtle Beach-N. Myrtle Beach-Conway	2.3%
Spartanburg	1.0%
South Carolina	0.9%

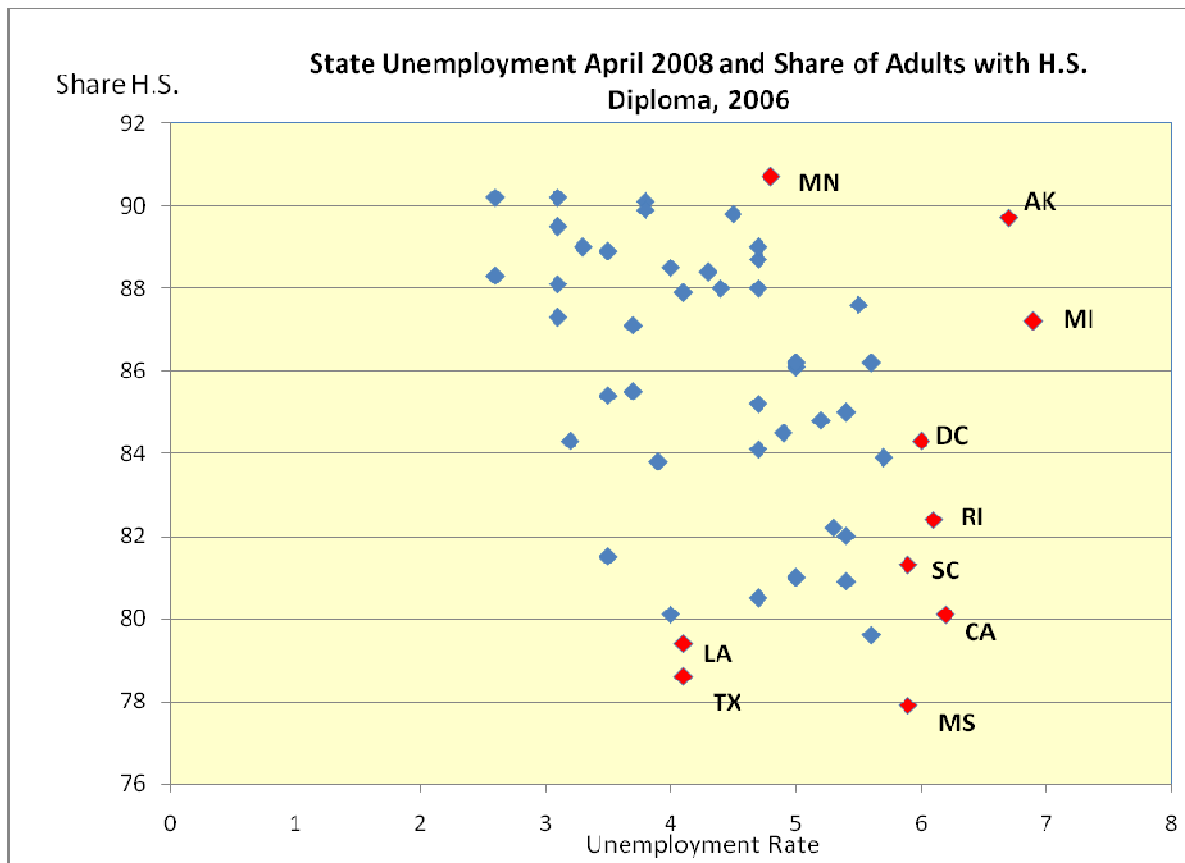
Housing start data for the three major state regions do not look so good. As indicated in the next chart, the real slowdown began in 2005. But with healthy employment growth and rising housing prices, we should expect to see recovery in 2009.



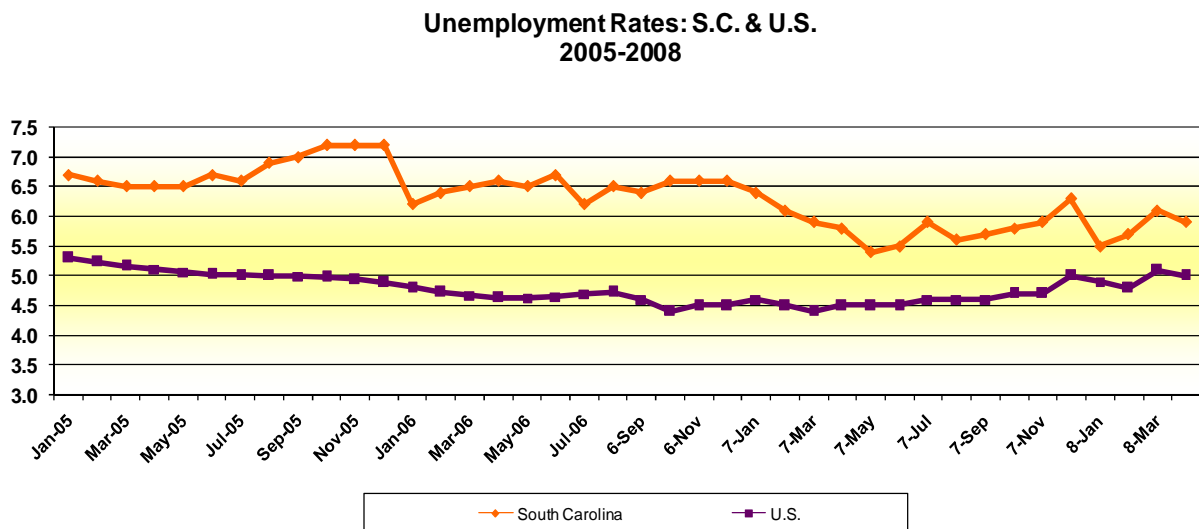
Unemployment and transitions

The relationship between education and employment is about as strong as the relationship between the law of gravity and falling objects. The next chart shows a mapping of the share of state population with a high school diploma for 2006 and the April 2008 unemployment rate. I have marked a few states that stand out because of where they are positioned. Several states along the right-hand border have higher unemployment rates than educational attainment suggests they should register. Most of these are transition states. South Carolina is one of them. Alaska and D.C. are special cases.

The chart also shows some states that have lower unemployment rates than their educational attainment suggests they should have. These include Texas and Louisiana. Louisiana is in a post-Katrina construction boom. Texas has a booming energy sector and a high powered knowledge economy.



Finally, consider the state unemployment rate and how since 2005 the rate is slowly converging toward the national number. The gap between the state and nation is still rather large. South Carolina is a state in transition.



Final thoughts

In a very real sense, economies are always in transition. Young and old alike are searching for happiness in a world of scarcity and opportunity. We seek to find partners who will share happiness with us, and we seek ways to build safer and stronger communities. We also seek peace.

Writing about the challenges we face in his forthcoming book, *Reflections of a Political Economist*, Bill Niskanen, able economist and chairman of CATO Institute, tells us that human beings organize relationships three ways. We engage in transactions with people we care about. We do things because we care for others. Then, we engage in market transactions. We do things for others in exchange for things they do for us. Finally, we organize on the basis of power. We do things for others to avoid the bad things they may do to us.

Economies are always in transition. Let us hope the transitions, at the margin, carry us away from power transactions and toward market and caring transactions.